MILITARY OFFSETS

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCE, CONSUMER PROTECTION, AND
COMPETITIVENESS

OF THE

COMMITTEE ON
ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

JUNE 22, 1994

Serial No. 103–138

Printed for the use of the Committee on Energy and Commerce

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CONTENTS

MILITARY OFFSETS

WEDNESDAY, JUNE 22, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, CONSUMER PROTECTION,
AND COMPETITIVENESS,
Washington, DC.

The subcommittee met, pursuant to notice, at 11:15 a.m., in room 2218, Rayburn House Office Building, Hon. Frank Pallone, Jr., presiding (Hon. Cardiss Collins, chairwoman).

Mr. PALLONE [presiding]. We are going to begin the hearing.

As you know, this is a hearing of the Subcommittee on Commerce, Consumer Protection and Competitiveness on the issue of offsets generated with U.S. Foreign Military Financing Program funds.

I wanted to point out that the chairwoman is testifying I believe before the Banking Committee right now, so she will be here within the next few minutes, but in the meantime, we do want to start.

We just have the one witness from the GAO, and I don't have any opening statement, other than to indicate that at some point during the GAO representative's testimony, I was hoping that there would be some analysis of how the offsets work in conjunction with U.S. foreign policy. In other words, one of the concerns I had is that the United States has long recognized, for example, Israel's unique role as the U.S.'s major ally in the Middle East, and that relationship is an important part of our foreign policy.

And I just wondered to what extent the contract and offsets that arise out of the concerns that are being raised here have taken into consideration the need for us to solidify defense cooperation with Israel, as would be true with some of the other countries that are affected. And whether that was a consideration that was done in the report by the GAO.

But I would like to see if the gentleman from Florida—would you like to make an opening statement?

Please.

Mr. STEARNS. Thank you, Mr. Chairman, and I want to thank the chairwoman, Mrs. Collins, for having this hearing to review the GAO's finding of their investigation into offset arrangements associated with foreign military sales, or FMS. I believe that their findings were interesting and deserving of further analysis.

It is no secret that the U.S. manufacturers produce the finest military equipment and weapons systems found anywhere in the world. Thus, it should come as no surprise that many foreign governments purchase this equipment for their own national defense.

Nor should it come as any surprise that it is often in the interest of the United States to assist foreign governments in the financing of their U.S. military equipment purchases.

The GAO discussed these advantages in their report. The cementing of government-to-government and military-to-military relationships, ensuring that America's friends and allies have access to the most technically advanced military equipment and training found anywhere in the world, and perhaps most importantly, the creation and sustenance of high-paying defense industry jobs here at home.

These are the reasons that the Foreign Military Financing Program was created, and that is why I was so surprised to learn that some of America's closest allies are benefiting far more from the FMF program than I think any of us ever imagined or intended. The GAO report reviewed four countries: Israel, Egypt, Greece and Turkey, and found all four received substantial FMF grants or loans, and also required contractors to provide so-called offsets.

The term "offset" is a general term for a variety of arrangements designed to ensure that foreign governments derive some greater benefit with the contract of the U.S. military supplier beyond the products specified in the contract. An offset can take the form of a coproduction arrangement where a U.S. contractor is required to purchase all or part of the weapons system in concert with a foreign manufacturer, or directed subcontracting where a U.S. manufacturer may have to subcontract part of a system to a foreign firm, or any one of a half a dozen other schemes outlined in the GAO report.

I am not questioning the authority or wisdom of foreign governments requiring offsets in contracts for military equipment when they are using their own funds. There are valid reasons for this.

However, when these countries use our money to purchase our equipment, we need to be careful about entering into any agreement that dilutes the positive effects of these sales on our own domestic economy.

When we are looking at these sales, Congress must first decide if we want to continue to condone the practice of using U.S. taxpayers' funds to not only arm our allies, but also subsidize our economy in the same transaction. If we decide that we want to end this practice, then we must decide what is necessary to achieve that goal, be it a change in existing law or executive branch policy.

Mr. Chairman, I look forward to hearing from our witness today, and I hope that he cannot only tell us more about offsets and their impact on the economy, but also about possible solutions to the problems that offsets may create.

Thank you, Mr. Chairman.

Mr. PALLONE. Thank you.

Would the gentleman from Pennsylvania like to make a statement?

Mr. GREENWOOD. No.

Mr. PALLONE. OK. Then we will start with our witness, who is Mr. Frank C. Conahan, Assistant Comptroller General of the National Security and International Affairs Division of the General Accounting Office.

STATEMENT OF FRANK C. CONAHAN, ASSISTANT COMPTROLLER GENERAL, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY DAVI D'AGOSTINO, ASSISTANT DIRECTOR, AND DAVID GROVES, EVALUATOR-IN-CHARGE

Mr. CONAHAN. Thank you, Mr. Chairman, members of the subcommittee. With me today are Davi D'Agostino and David Groves of my office.

We really appreciate the opportunity to be with you this morning. I think that this is an extraordinarily important issue that this subcommittee puts before the Congress and the American people.

It has been with us for some time; I think this subcommittee has permitted us to assist it in ferreting out some of the basic reasons that it continues, the trends that it is taking, and at the invitation of Mr. Stearns, at the end perhaps some recommendations to get to the bottom of what we are dealing with right here.

We are going to talk about the four countries, Israel, Egypt, Turkey, and Greece. The reason that these four countries were included in our review is because they account for almost all, virtually all, of the foreign military financing that is provided by this government. I would like to say at the outset that these countries benefit in two ways:

First, they benefit with the U.S. Government funding or underwriting their weapons purchases with grants or loans, and then by developing their industrial bases or other aspects of their economies, and I think that it is important that we understand that both of those dynamics are at work here.

As you members are keenly aware, these offsets reduce employment, they adversely affect the defense industrial base, and there are other economic benefits that accrue to the recipients of this financing that would ordinarily accrue to U.S. contractors and their subcontractors. These offsets in fact do result in a loss of work to both prime contractors as well as subcontractors, and we can talk a little bit more about that, and a flow of business from our shores to these countries. On top of that, the U.S. Government pays both for some of these offsets and for the costs of the offsets.

At the outset, I think it is important to note that U.S. law, policy and regulations do not prohibit offsets with foreign military financing funds. There have been statements made in this regard, but I would like to lay before the committee that that prohibition simply does not exist.

Now, the key here is the President's 1990 offset policy, which says essentially that, U.S. Government funds shall not be used to finance offsets when security assistance funds are involved, except in accordance with currently established policies and procedures. And I would like you to take that into account, the quotation is "except in accordance with currently established policies and procedures." That language was subsequently incorporated into the Defense Production Act in 1992.

The problem here is that neither the policy nor the legislation set out what is meant by "currently established policies and procedures." And at the time of the policy and at the time of the legislation, offsets were occurring, the kinds that were spoken about here a moment ago. We are talking about coproduction, buybacks, as

well as others. But the policy does not really prohibit U.S. funds from being used for offsets in these sales. I think that is an important first point.

Second, I would like to make the point that offsets are either direct or indirect. In the case of direct offsets, it is pretty easy to see the linkage there between the transaction on our side and the transaction across the oceans. In the second case, in indirect offsets, it is a little less clear.

But let me talk just a little bit about direct kinds of offsets: First, coproduction—and that is where we permit a foreign country to produce part of a weapons system. One cited in our report had to do with Turkey, where we permitted Turkey to produce parts and components and to assemble them into a final weapons system, and that transaction was worth $760 million to Turkish companies.

In a buyback scheme, we permit FMF recipients to produce components, the prime contractor simply buys them for incorporation into a weapons system which, in turn, is sold to the U.S. Government or to a foreign government. But in any event, we have a situation here where the buyback is financed by the U.S. Government. We have examples of buybacks amounting to the hundreds of millions of dollars in our report as well.

We also have indirect offsets discussed in our report. I would like to say here that these offsets involve not only defense products, but nondefense products as well.

As I said, U.S. funds pay for some of these offsets, and a number of those examples are included in our report as well.

In one deal that stands out, and that has to do with Israel in this case, Israeli companies were paid to produce parts that were incorporated into weapons systems that the United States provided to Israel free of charge. Now, a good bit of that program is on a grant basis, but I think that when you want to see how offsets really work, you want to follow that one through. We are providing the Israeli contractor the funds in order to produce items, with the prime contractor buying those items, and then, through our grant aid program, providing the system to that government free of charge.

I think I should move quickly to our conclusions. We believe that offsets are a questionable use of foreign military financing funding. The reasons cited both from the podium and here earlier with respect to employment and loss of business from our community are well established. Our report contains a number of specific instances where contractors and subcontractors were adversely affected.

I think what I would like to say here is that we have got to take a look at offsets, coproduction, buybacks, investments and all the rest in the context of the international marketplace. These transactions do occur in normal commerce and we have to understand that they do occur and will continue to occur.

However, I think what we need to focus on here is that when U.S. taxpayers' money is directly involved, consideration should be different than the marketplace—free of U.S. taxpayers' funding—is at work. In sales financed by the U.S. Government, there is no foreign competition. These funds for the most part, except under certain limited conditions, need to be spent in the United States on U.S.-produced weapons. So you have got one U.S. company compet-

ing with another company; you don't have one U.S. company competing with a foreign firm, so that foreign competition is not at work here. I think that is important. U.S. companies are competing with one another.

One wonders, then, if allowing offsets would be appropriate in U.S. grant-funded cases where the business is going to end up in the United States in any event.

We are offering in our report a number of very specific recommendations which would preclude the use of grant financing to finance contracts involving offsets, as well as some means to enforce this. We recognize that enforcement in the international marketplace, notwithstanding U.S. Government involvement would be difficult, but we think it is doable and we can talk about some recommendations that we think might work there.

Perhaps I can stop there, Mr. Chairman, and take your questions.

[Testimony resumes on p. 17.]

[The prepared statement and attachment of Mr. Conahan follow:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Commerce, Consumer Protection, and Competitiveness, Committee on Energy and Commerce, House of Representatives

For Release on Delivery
Expected at
11:00 a.m., EDT,
Wednesday,
June 22, 1994

MILITARY SALES

Concerns Over Offsets Generated Using U.S. Foreign Military Financing Program Funds

Statement by Frank C. Conahan, Assistant Comptroller General, National Security and International Affairs Division

Madam Chairwoman and Members of the Committee:

It is a pleasure to be here today to discuss the results of our report on offset arrangements associated with foreign military sales financed through the U.S. Foreign Military Financing (FMF) Program.[1] Various companies, countries, and government agencies define offsets differently--some even call offsets by other names, such as industrial participation or cooperation. For purposes of our review, we define offsets as an entire range of industrial and commercial compensation practices provided to foreign governments and firms as inducements or conditions for purchasing military goods and services.

When buying weapon systems with their national funds, foreign countries commonly require offsets to reduce the financial effects of making large weapons purchases abroad and make them more politically palatable domestically. Our work focused on countries that require or request offsets when purchasing weapons from the United States with U.S. grant aid (cash assistance) or loans through the FMF program.[2]

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[1]Military Exports: Concerns Over Offsets Generated With U.S. Foreign Military Financing Program Funds (GAO/NSIAD-94-127, June 22, 1994).

[2]Grants represent assistance for which the United States receives no dollar reimbursement. Grants generally refer to military assistance program funds, non-repayable or forgiven foreign military sales credits, and repayable foreign military sales credits that were later forgiven. On the other hand, loans generally refer to direct loans or repayable foreign military sales credits that are made at either market or concessional rates.

Over the years, we have reported on various offsets connected with foreign military sales. In this review, we examined in detail 48 contracts valued at $11.6 billion with the four largest recipients of FMF assistance--Israel, Egypt, Turkey, and Greece--along with the $4.7 billion in associated offset obligations.[3] We also traced the offsets through the companies' financial records and determined whether and how U.S. government funds paid for the offsets and their costs. Finally, we made observations on the impacts of these offsets on U.S. business, trade, and industrial competitiveness.

RESULTS IN BRIEF

The U.S. FMF program has been justified to the Congress based on its role in (1) strengthening the security of friendly and allied countries and (2) benefiting the U.S. industrial base and employment because the funds are generally to be spent buying U.S. goods and services. However, current U.S. laws, policies, and regulations do not preclude offsets when recipients are making purchases with FMF funding.

Using U.S. FMF funds, Israel, Egypt, Turkey, and Greece benefited in two ways--first with the U.S. government funding or underwriting

[3]Specific information about offset arrangements was considered proprietary by the U.S. contractors. As a result, information is provided in summary form, and the contractors are not identified.

their weapons purchases with grants or loans, and then by developing their industrial bases and other aspects of their economies through offset requirements from the U.S. government or contractors. Offsets reduce the employment, defense industrial base, and other economic benefits that normally accrue to the United States from weapons exports. Certain types of offsets have resulted in a loss of some production work and business for U.S. prime contractors and subcontractors as well as for companies in nondefense businesses. On top of this, FMF grants and loans or military procurement funds actually pay for some offsets and their costs.

Department of Defense (DOD) officials stated that no other arms supplier provides a combination of grant aid and offsets like the United States.

U.S. LAW, POLICY, AND REGULATIONS DO NOT PROHIBIT OFFSETS WITH FMF FUNDS

Current U.S. laws, policies, and regulations do not preclude FMF recipients from requiring, requesting, or obtaining offsets when they purchase U.S. military goods and services using FMF funding. The Arms Export Control Act provides that FMF grants and loans should not be used for coproduction, licensed production, and procurements outside the United States except under certain limited conditions. But this Act and other applicable laws do not prohibit

foreign countries from using FMF grants and loans to obtain offsets from U.S. weapons suppliers.

The President's 1990 offset policy includes an exception that is not defined and actually allows U.S. government funds to pay for offsets in security assistance transactions. Although the policy says that U.S. government funds shall not be used to finance offsets in security assistance sales except in accordance with currently established policies and procedures (emphasis added), it does not spell out what "currently established policies and procedures" are. Under the policies and procedures existing in 1990, many types of offsets, including coproduction and designated work, were occurring in connection with sales financed with U.S. FMF grants and loans. As a result, this policy does not really prohibit U.S. funds from being used for offsets in security assistance sales. This policy was later incorporated into the Defense Production Act in 1992.

RECIPIENTS LEVERAGE OFFSETS WITH U.S. FMF FUNDS

To varying degrees, Israel, Egypt, Turkey, and Greece are using U.S. FMF program funds to obtain offsets. Offsets are either direct--related to the weapon system being bought--or indirect--related to other products and services. As shown in attachment I,

$4.7 billion in offset obligations were generated from the $11.6 billion in contracts we reviewed.[4]

Direct offsets associated with the FMF contracts we examined included coproduction and buybacks:

-- Coproduction agreements permit a foreign country to produce all or part of a U.S. weapon system overseas. In the cases we reviewed, coproduction activities valued at $1.2 billion took place in Turkey, Israel, Greece, and Egypt. In one case, for instance, using FMF assistance and national funds, Turkey produced parts and components and assembled the final weapon system valued at about $760 million.

-- Buybacks involve the U.S. contractor enabling the foreign country to produce defense components directly related to the U.S. military system being acquired and then purchasing these components from the foreign country. Buyback arrangements have been made with Israel, Turkey, and Greece. For example, Israel and Turkey were sources of buybacks valued at $631.2 million and $316.9 million, respectively.

We also saw a variety of indirect offsets in the cases we reviewed:

-- Procurements involved purchases of foreign-produced components of weapon systems other than those being acquired. For example, to implement an offset for purchasing a U.S. tank, a contractor might buy aircraft parts from the purchasing country. In the cases we reviewed, U.S. contractors made most of these types of purchases from Israel and incorporated them into weapon systems or commercial items that were purchased by U.S. and foreign customers.

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[4]Because our selection of cases represented a small percentage of military sales, the results of our work cannot be projected to a larger universe of military offset arrangements.

-- Investments in non-defense firms involved establishing corporations in Greece and Turkey to invest capital in companies in those countries. For example, U.S. contractors financed a Greek corporation, which in turn invested in companies engaged in medical diagnostics, sportswear manufacture, computerized numerically controlled wire-bending machines, software systems for the financial services industry, and woven and nonwoven textiles.

U.S. FUNDS PAY FOR SOME OFFSETS

FMF grants and loans and U.S. military procurement funds have been used to pay for items produced overseas under offset agreements, and for some costs associated with offsets. In some cases, such as coproduction or directed subcontracting, the use of FMF grants and loans to pay for or finance offsets is clear. In other cases, such as buybacks and other procurements, the U.S. government, as an ultimate buyer, pays for foreign-made components that are included in U.S. weapon systems purchased by the U.S. military services as a result of the offsets.[5]

-- The cases we reviewed included FMF grant-funded coproduction and directed subcontracting valued at about $387.9 million. For example, Israeli companies were paid to produce parts that were incorporated into weapon systems that the United States provid i to Israel free of charge.

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[5]U.S. contractors stated that buybacks and other procurements were made at competitive or reasonably competitive prices and did not result in extra costs to the government. Nevertheless, buybacks and other procurements result in additional foreign content in U.S. weapons.

-- The U.S. military services and other customers purchased weapon systems that contained about $1.5 billion in components acquired through buybacks or other procurements made by the U.S. contractors. Of this amount $1.2 billion in buybacks or other procurements were made from Israel. Neither we nor the contractors could quantify or distinguish the total amount of U.S. funds used for these purchases.

Because the purchase prices of foreign-produced parts and components are ultimately paid by customers, including the U.S. military services, the actual out-of-pocket costs of offsets to the U.S. contractors are substantially lower than the total amount of the offset obligations.

OFFSETS ARE A QUESTIONABLE USE OF U.S. FMF FUNDING

While FMF grants and loans support U.S. foreign policy and security objectives, certain types of offsets reduce the employment, industrial, and other economic benefits that normally accrue to the United States from foreign military sales. Some offsets require U.S. contractors to place subcontract business offshore with recipient countries' industries that might have otherwise been performed in the United States. Our review indicates that offsets can result in displacement of U.S. subcontractors and create new competitors for U.S. companies in the world market.

Although the long term impact of offsets on overall U.S. trade and employment depends on a number of factors, effects of offsets on certain industries and firms can be identified. Our report

84-119 O - 94 - 2

discusses a number of anecdotal cases in which offsets connected with sales funded wholly or partially with grant aid adversely affected U.S. companies' business. I will highlight two of these cases for you.

-- Because of buyback arrangements with Israel, a U.S. subcontractor that originally supplied a subsystem was no longer producing the item. In this case, the U.S. subcontractor was displaced by an Israeli supplier for that item. According to the subcontractor, this significantly affected the company's operation and reduced yearly revenues by about $2 million, or almost 15 percent.

-- In another case, U.S. prime contractors provided Turkey with the capability to produce parts and components that were incorporated in the weapon system sold to Turkey as well as components purchased back to be included in U.S. weapon systems. Two subcontractors told us they lost work that could not be replaced. Both U.S. companies noted that as a condition of their contracts with the U.S. prime contractor, work had to be given up so that the prime contractor could satisfy its offset obligations.

While offsets are an integral part of the world marketplace, they are not needed to assure a sale of a U.S. weapon system and may not be appropriate when the purchasing country is using FMF funding. According to DOD officials, the FMF grant aid program is unique in the world. No other arms supplier has a program that provides a combination of grant aid and allows offsets. In sales financed with FMF funding, especially FMF grant aid, foreign competition is not a factor because these funds are generally intended to purchase U.S. military goods and services. Instead, U.S. companies are competing against each other for FMF grant-funded purchases.

In discussing the possibility of prohibiting FMF recipients from using FMF funds to require offsets, both DOD officials and the U.S. contractors we contacted voiced concerns about a prohibition on obtaining offsets using FMF loans because the recipients repay these loans with their national funds. We agree that FMF recipient countries intend to repay FMF loans with their national funds. However, some loans have been provided at concessional rates or have been forgiven at a later date.

DOD and contractor officials also noted it would be extremely difficult to enforce a prohibition on offsets using FMF grant funds. To ensure enforceability, contractors could be required to certify that they have not and will not provide offsets in connection with grant-funded sales. Certain contractor representatives noted that the United States could also include a prohibition on requiring or obtaining offsets as a condition of the grant aid.

Our report makes some suggestions to the Congress for amending current legislation to prohibit the questionable use of FMF funds and to help with the enforceability of the new laws.

Madam Chairwoman, that concludes my statement. I will pleased to answer any questions that you or other Committee Members may have.

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TYPES OF OFFSETS AND ASSOCIATED OFFSET OBLIGATIONS

Dollars in millions

Types of offsets	Cases[a]	U.S. contractor offset obligations
Direct offsets		
Coproduction arrangements	9	$1,155.0[b]
Buybacks (related to the system)	11	941.1
Directed subcontracting	6	14.9
Investments (defense firms)	3	159.4
Concessions	10	166.3
Technology transfers/licensed production	15	[c]
Indirect offsets		
Procurements (unrelated)	11	584.3
Various offsets	2	901.0[d]
Investments (nondefense firms)	1	33.0
Trading of commodities	5	545.1[e]
Foreign defense-related projects	6	226.7
Total		$4,726.8

[a]Many of the cases we reviewed involved more than one type of offset. Therefore, the number of cases displayed in this table exceeds our sample quantity of 48.
[b]The contractor could not quantify the value of parts and components purchased from one country. As a result, this figure does not include that amount.
[c]The values of these offset obligations were not quantified because they were based on subjective judgments or not known in all situations.
[d]Through subsequent negotiations between the U.S. contractors and the FMF recipients, these offset obligations were later satisfied with U.S. contractor investments in nondefense firms. These investments cost $37.8 million.
[e]Offset obligations amounting to $28 million could be satisfied through either the trading of commodities or foreign defense-related projects.

Mr. PALLONE. Thank you, Mr. Conahan.

As I said before, the—I guess my initial question is whether or not—to what extent the study was keeping in mind U.S. foreign policy goals, and I know that is a difficult question, because you maybe don't necessarily look at it from that perspective. But if you could comment on that, and specifically, I am going to use Israel as an example, but I am sort of assuming that what I am going to say about Israel probably may very well apply to each of the governments that you mentioned.

But in the case of Israel, you know, because of its unique relationship with the United States, because it is the bulwark, if you will, of our best allies, so to speak, in the Mideast, one of my concerns has always been—and this is what we hear, you know, in terms of trying to support Israel, is the need for this qualitative military edge over its neighbors in the Mideast.

And I guess I have been operating under the assumption that when U.S. companies assist Israel in developing, you know, its infrastructure, its defense infrastructure, whatever, that, you know, it helps in terms of maintaining the qualitative edge. So I am just wondering to what extent those considerations have been taken into play here.

In other words, doesn't it help the maintenance, if you will, of this qualitative edge in terms of technology to have this kind of cooperation with U.S. companies that results from these offsets. Is that something that has been considered in the GAO report?

Mr. CONAHAN. Right from the outset of our consideration of this whole matter, Mr. Chairman, are the purposes for which we have got the Foreign Military Financing Program in the first place. And they are in support of our national security objectives, and I think we have to take that into account.

With specific regard to Israel and Egypt, we can go back to the Camp David Accords, or indeed we can go to a period before that so that we can include Turkey and Greece, which are the other two countries here, and the provisions of law that have existed for a long period of time were in that overall Cold War context. And, therefore, our programs in those countries were certainly in consonance with those objectives over a long period of time.

I don't think that there is any suggestion, at least in this forum right here today, that those issues or objectives are in question, and I think they really do need to be taken into account.

So the first part of the transaction—the offset—which is the provision of assistance to those governments, I think is in keeping with those objectives and we would fully support that.

Now, when you get to the second part of the transaction—the offset—which has to do with the secondary benefit to these governments from that, then we begin looking beyond the initial objectives to the issue of support of their economies, their industrial bases, such as you suggest.

Now, the administration successively over a long period of time has been saying that security assistance is being made available: (1) to support our foreign policy objectives, to support our friends and allies and the common and mutual defense of our interests around the world, but (2) to support our industrial base and the

business base of this country, because these funds are being spent in the United States.

I think what we have before us today is the issue of how these funds are also being spent in such a way as to benefit the industrial base and the business base of some of our friends and allies to the detriment of the United States' industrial base and business base.

Mr. PALLONE. I guess what I am saying, and I know it is a difficult question, is that if the only effect of offsets in the case of Israel—but, you know, as you say, we probably could apply this to all four countries—is that it creates more jobs in Israel and their economy benefits, then that would be somewhat specious I guess in terms of trying to make that argument that that is a good thing to do.

But on the other hand, what I am saying is, isn't it, in fact, the case that it goes beyond that and that these kinds of offsets actually help in terms of their maintaining a military superiority, or that the type of cooperation that results gives them a qualitative edge from the defense point of view that might suffer in the absence of the offsets. In other words, if it was just jobs and the economy, then I think, you know, the case would be—it would be easy to make, you know, why should we be creating jobs there if we are losing jobs here?

On the other hand, if there is some benefit from a defense point of view, because of the cooperation or because, you know, doing some of these things in Israel, for example, actually helps them keep their qualitative edge, that is I guess—is there an argument there, or would you say that is totally specious?

Mr. CONAHAN. Oh, no, I don't think it is necessarily totally specious, but I think that one needs to analyze that. We are providing certain frontline equipments to Israel, and we are giving them an opportunity to produce part of those equipments as well as to maintain them.

On the other hand, we are similarly providing frontline equipments to, for example, Saudi Arabia and others on the other side of that equation sometimes providing them with an opportunity to support those equipments as well.

I think you have to take it in both slices. Yes, we are assisting them in providing for their own defense as well as for our mutual objectives and I think that is a good thing. I take no question with that.

But we are also doing that on the other side. As a matter of fact, we issued a report back in the early 1980's where we talked about the implementation of the Camp David Accords at that time, and it was the very first time that we began seeing Israel getting offsets and other concessions that Egypt and other FMF recipients were not getting in the foreign aid programs, and we said that the way the administration at that time was carrying it out would have a spiraling effect on these aid programs as they developed over time.

I suggest, Mr. Chairman, that we are seeing that spiraling effect occurring right now.

Mr. PALLONE. OK. Thank you.

Mrs. COLLINS. Mr. Stearns.

Mr. STEARNS. Good morning, Madam Chairwoman.

Mrs. COLLINS. Good morning. Let me say before you begin your testimony, that I was offering testimony in another committee; that is why I was not here at the beginning of this hearing. You may proceed.

Mr. STEARNS. We are delighted that you are here, and we missed you.

Let me just follow up a little bit in an overall statement. Do the offsets, from the aspect of increasing the price of military equipment and reducing the amount of military equipment, that nations receiving foreign military financing can buy—now, for example, the GAO, your report found that the cost of the M-1A ABRAM's tank produced for the government of Egypt increased from $3.6 million per tank to $5.2 million per tank because of the coproduction arrangement. And if the tanks cost $5.2 million apiece rather than $3.6 million apiece, does that mean that Egypt can buy fewer tanks with its FMF money?

Mr. CONAHAN. The short answer to your question is yes. In that case, the cost of the tank was greater than if it was sold directly by the United States and therefore the buyer with the same amount of money could obtain fewer tanks. And we find that frequently as we look at coproduction projects. Even in those cases where foreign military financing is not an integral part of the transaction, we find that as well.

For example, in the coproduction of frontline aircraft with Japan, we find that Japan is willing to pay much more on a unit cost basis for frontline fighter aircraft than if it bought directly from the United States.

There are, on the other hand, cases where the foreign producer is more efficient than the U.S. producer and therefore the final cost to both the prime contractor and the customer would, in that case, be less.

Mr. STEARNS. Are the cases—I want to talk about—that these countries then actually use the technology they develop to sell it to countries other than us and become competitors with us?

Mr. CONAHAN. Yes, sir, that is certainly true. I think Turkey is probably a good example here. As part of the sale of our frontline aircraft to Turkey in the mid-1980's, we agreed on an offset arrangement to set up an assembly facility in Turkey and also to shift production into that facility.

As part of the second major buy of that weapons system, we agreed to shift additional coproduction into that facility in Turkey, amounting to hundreds of millions of dollars. When President Bush visited that part of the world during the Persian Gulf affair, he committed that we would assist that assembly operation in Turkey.

Now, the one thing that he did not agree to is the Turkish Government continued asking us to permit them to sell that system to third parties.

Mr. STEARNS. Do they have to ask us?

For example, let's get back to the case of Egypt. We had a case where the Government of Egypt was talking to the Japanese companies about converting its tanks in a plan to produce heavier equipment. Isn't it true that Egypt was even seeking FMF funding for that conversion?

Mr. CONAHAN. Yes. Yes, sir.

Mr. STEARNS. So basically we have the Government of the United States helping another country, in this case, Egypt, to develop using our technology, they become the manufacturer, and then they try and take that manufacturing ability and sell it to another country and ask us to help them sell it to another country, the technology we gave them and we are subsidizing their manufacturing, overall; is that true?

Mr. CONAHAN. That is absolutely true, yes, sir. Let me add to that. That is a concern around the world, and I think that we need to focus on it.

In the case of Korea, the coproduction projects there have permitted them to sell in the Middle East and elsewhere. In the case of Japan, our coproduction, codevelopment and other production of products there have permitted them to develop a civil aircraft industry which is now competing with us, and you are finding the same thing now in some of these countries that are more reliant on us under the Security Assistance Program.

Mr. STEARNS. I would think to add to a concern around the world, probably should be concern for taxpayers, too, because they are, you know, paying the bill in this case.

How long has offset coproduction been going on? Is this a relatively new thing that has this been going on for 30 or 40 years?

Mr. CONAHAN. I don't have personal knowledge as to how long it has been going on. It certainly has been going on for the past 15-odd years. We can cite instances going back to the very early 1980's where this occurred.

Now, also, it was occurring not only in the international marketplace, but it was also occurring with the assistance of U.S. Government financing.

Mr. STEARNS. We have here that the first example of coproduction involving American defense contractors was the F-104 and Hawk anti-aircraft missile system with European countries—nations in the late 1950's. So I mean this has been going on for more than 14, 15 years.

You know, the real question is how much actual damage has been done to the American economy? How much have taxpayers suffered? And what should we do to prevent countries to not only undercut our ability to compete, but just increase the cost of these things.

Mr. CONAHAN. I don't think that we can quantify the overall effect on the economy of the United States. Now, we do have a number of examples in our report of U.S. companies negatively affected by offsets. With respect to one buyback arrangement with Israel we found that a supplier had lost considerable business as far as he was concerned.

It amounted to $2 million a year in his case. But that was 15 percent of his total business, and to him, that was a substantial amount. And we can go on with other examples. And there are those kinds of amounts, but those kinds of amounts are very significant to individuals out there.

Now, but there is a cost not only to the economy, but there is also a cost to the American taxpayers, as I said, a two-fold cost to that, and then there is a cost to the company itself. To the extent

that the American taxpayer or another customer is not funding these costs, then the contractors are. And may I suggest that there are some substantial costs of these offsets to the contractors out there in this.

Mr. STEARNS. Thank you, Madam Chairwoman.

Mrs. COLLINS. Thank you.

Mr. Greenwood?

Mr. GREENWOOD. Thank you.

I have studied this issue extensively now for about 25 minutes and I feel prepared to take action.

My analysis so far tells me that what seems to occur here is that there is fierce competition among defense contractors for these significant contracts; that it is technically illegal for the contractors to offer kickbacks to those nations, which would be a simple way to gain a preferential position; and so over time they have developed these more creative kickbacks, if you will, to the countries. This situation is undermining our economy, and it is undermining the intent of our military assistance to these countries.

From my study so far, it would seem to me that what we ought to do is simply flat out ban it and have the contractors compete with one another strictly on price, which would result from their own efficiencies, and so forth. Can you see any reason for us not to simply make these kinds of offsets illegal?

Mr. CONAHAN. Our explicit recommendation is that they be made illegal, when U.S. grant financing is involved. And we can talk about the definition of that.

However, when it comes to a loan financing, I think it gets a little more dicey. Other governments do provide loans in combination with offsets, and I think we have to be careful with that. When there is real competition between a U.S. contractor and a foreign contractor, then I think we have to make sure that we are not in the way of, or impeding our own contractors there.

But your recommendation explicitly is ours with respect to grant financing, yes, sir.

Mr. GREENWOOD. OK.

The difference being with the grant financing, that it is always just one U.S. company versus another, as opposed to the loan financing where there are foreign companies——

Mr. CONAHAN. With a very small exception to that in Israel. Israel is specifically authorized to spend $475 million of its annual $1.8 billion in U.S. grant military aid in Israel.

Mr. GREENWOOD. OK. So when there is no foreign competition, these offsets should become a thing of the past?

Mr. CONAHAN. That is our position, yes, sir.

Mr. GREENWOOD. OK. And those who might argue that we are achieving some indirect assistance to these same countries, whether it is Egypt or Israel, or Turkey or Greece, by having them develop industry on their territory. But that is not a very good argument, because if we want to do that, we should do it in a way in which we are controlling the process as opposed to this sort of random mechanism. We are not distinguishing whether or not they are competing with our own subcontractors; is that right?

Mr. CONAHAN. I think, Mr. Greenwood, that when the executive branch of government and the legislative branch of government get

together and decide on a national policy to do A, B, or C, fine. What we have in this case are laws and regulations which really obfuscate what is going on out there, and I think that once we agree on whatever that is, fine.

Our position is that it is not necessary to provide offsets in combination with this financing for the reasons that you just articulated in these cases.

Mr. GREENWOOD. My guess is that the contractors over the years have been willing partners in this competitive offset business when it was to their advantage to be offering the best offsets. But it would be my guess that they would prefer to return to a level playing field. Is that your sense—that if they knew it was going to be across the board, that they would not resist this?

Mr. CONAHAN. My sense is that if indeed it was across the board, if indeed we achieved a level playing field, which means that the law and regulation could indeed be enforced, that it would make their lives easier and that they would be willing to go along with that. Some of them did express that to us.

What they are concerned with is that we are not going to be able to enforce this adequately, and that these practices will continue to their individual detriment.

Mr. GREENWOOD. Thank you, Madam Chairwoman.

Mrs. COLLINS. Well, first of all, let me thank Mr. Pallone for beginning the hearing. I know that none of us wanted to be sitting here waiting while I testified over in the other subcommittee. And now that I am here I want to welcome everyone to this morning's hearing of the Subcommittee on Commerce, Consumer Protection and Competitiveness.

The subcommittee has asked the General Accounting Office to testify on the report released today concerning its investigation of offset arrangements associated with foreign military sales financed through the United States, Foreign Military Financing Program, called the FMF. This investigation was conducted at the request of our subcommittee.

Out the outset, let me say that I do not hold the foreign governments that demand offsets responsible for the situation that GAO's report describes. It is natural that foreign governments should want as much work to be done in their own country as possible. Nor do I blame U.S. defense contractors, which use all resources, including offsets to make the most competitive bids possible. Instead, the responsibility for the offset problem that the GAO has identified lies squarely with our government. The United States is the only country which allows offsets to be paid for out of government-funded grant aid programs.

For years the Congress has expressed concern over offsets or concessions which defense contractors agree to in order to sell weapons systems to foreign governments.

I am going to ask to have my statement put in the record at this point in the record.

[The opening statement of Mrs. Collins follows:]

OPENING STATEMENT OF HON. CARDISS COLLINS

I want to welcome everyone to this morning's hearing of the Subcommittee on Commerce, Consumer Protection, and Competitiveness.

The subcommittee has asked the General Accounting Office to testify on the report released today concerning its investigation of offset arrangements associated with foreign military sales financed through the U.S. Foreign Military Financing (FMF) Program. This investigation was conducted at the request of the subcommittee.

At the outset, let me say that I do not hold the foreign governments that demand offsets responsible for the situation that GAO's report describes. It is natural that foreign governments should want as much work to be done in their own country as possible. Nor do I blame U.S. defense contractors which use all resources, including offsets, to make the most competitive bid possible. Instead, the responsibility for the offset problem that GAO has identified lies squarely with our government. The United States is the only country which allows offsets to be paid for out of government-funded grant aid programs.

For years the Congress has expressed concern over offsets, or concessions, which defense contractors agree to in order to sell weapons system from suppliers located in the foreign country. Offsets could also include a defense contractor's commitment to assemble the weapons system in a foreign country. More often than not, offsets involve giving work to foreign firms that would otherwise be done here in the United States.

When U.S. and foreign defense contractors are competing for weapons sales to a foreign government, what each contractor is willing to do on offsets may determine who gets the sale. An important finding in GAO's report is that even when there is no competition with foreign defense contractors and the U.S. taxpayer is financing a foreign government's purchase of a U.S. weapons system, foreign governments demand, and our defense contractors still pay, offsets.

Furthermore, GAO found in its investigation that taxpayer funded financing provided under the Foreign Military Financing program was used not only to cover the purchase of weapons systems, but also to pay for the cost of offsets demanded by foreign governments. As a result, in these cases, American taxpayers are actually paying to move defense-related production, and American jobs, to foreign countries.

GAO has also identified how specific U.S. firms were hurt by offsets granted in connection with arms sales to Israel, Turkey and Egypt. One subcontractor saw his annual revenues drop sharply; another was forced to license his product design to a foreign firm. In one case, a prime defense contractor was forced to do assembly work in the foreign country, which contributed to a decision to close a major facility here in the United States.

Offset requirements of this type, in my view, cannot be justified and are fundamentally inconsistent with the interests of the American people who are financing the sales with which they are associated. At a time when the American public is being told our Nation cannot afford to include the cost of prescription drugs and long-term care in the proposed national health plan, we must stop using scarce Federal revenues to put Americans out of work.

On the basis of GAO's findings, I must conclude that the government's current policy on offsets has failed. It is time to re-examine that policy, and I look forward to hearing GAO's recommendations on how this problem might best be addressed.

Mrs. COLLINS. Now, my first question is to please let me get something clear at the outset. Am I correct that this is the first time GAO or anyone else has ever identified offsets associated with specific defense contracts, the fact that taxpayers' dollars have been used to pay for them, and how offsets have displaced manufacturing jobs here in the United States, Mr. Conahan?

Mr. CONAHAN. I think, Madam Chairwoman, that the subcommittee has provided an opportunity here to provide to the rest of the Congress and to the American people sufficient evidence to demonstrate that this is widespread, pervasive, and that our major contractors and subcontractors are involved in this kind of an activity. I think that it has permitted us to lay before you the specific kinds of offsets that are occurring out there, and to associate the amounts of money, the very, very large amounts of money that are involved.

Now, these four countries that we reviewed received something on the order of $60 billion of this kind of assistance since 1975. Now, that is a long period of time.

We looked at something over $11 billion worth of that assistance and came up with offsets associated with just those contracts of $4.7 billion. That is a fairly extensive level of offsets against that kind of a base. We were then able to see how the U.S. Government was involved in funding or financing that.

One thing I would like to say, Madam Chairwoman, is that the assertions by the successive administrations is that they really haven't been involved in this, that this is a creation of the contracting community. It needs some elaboration, because the U.S. Government has clearly been part of this over the years.

As a matter of fact, when it came to some coproduction, they, to use my word, "directed" the contractors to get involved in that, so that they have a major role in that, and the law and the regulation permits them to do that. Indeed, both prime contractors and subcontractors are adversely affected by this.

Mrs. COLLINS. Am I correct, then, that your report does not take issue with offsets that may be associated with arms sales financed with a foreign country's own national funds. Instead, is not GAO's criticism like mine, the criticism of our Government not having an effective policy to prevent taxpayers' dollars from being used for offsets associated with arms sales financed by our Government.

Mr. CONAHAN. I agree with you fully, Madam Chairwoman. I think what is important about that is that other countries are also playing this game and we want to make sure that we don't put our contractors at an unfair disadvantage when the marketplace is at work. But when U.S. taxpayers' moneys are involved through the Foreign Military Financing Program, we see no need for it whatsoever.

Mrs. COLLINS. Well, my concern is that taxpayers ought not to pay to export good manufacturing jobs to foreign countries. I would like to ask you some questions about an offset requirement you identified in the report involving Turkey.

In this sale, Turkey requested that the U.S. defense contractor set up a facility to assemble the weapons system in Turkey rather than in the United States. Now, was that a recent sale and what was the dollar value of the sale and the offset?

Mr. CONAHAN. What was the dollar value of the sale? This is a continuing program with the Government of Turkey. Mr. Groves remembers that the initial sale was $4.2 billion. But Turkey at that time required an offset which involved both assisting them in establishing an assembly facility as well as permitting them to produce parts at that facility.

Now, the amount of the offset at that time, and I have the amount right here, $363.5 million, and that was a transaction that was done initially in the mid-1980's. Now we have had follow-on transactions to that since that time. And the most recent discreet follow-on to it involved more coproduction at that facility amounting to almost $400 million.

So you are talking about three-quarters of a billion dollars in offsets associated with that particular transaction in Turkey.

Mrs. COLLINS. Well, since this offset involves setting up a facility in Turkey, and given the high dollar value of the offset alone, would I be wrong to assume that the weapons program involved

was aircraft, and if so, which aircraft was it and who was the manufacturer?

Mr. CONAHAN. Well, I suppose that one can hardly not specifically answer that question. It has to be the F-16, it is the F-16. At that time, it was General Dynamics and General Electric that provided the engine. We are now talking about another contractor. But it was the F-16 and it was those contractors.

Mrs. COLLINS. Your report said this assembly work would have been done in our country, in the United States. Is this true, and if so, did the assembly work in Turkey cause the U.S. contractor to cut back his operations here and American workers to lose their jobs?

Mr. CONAHAN. You cannot quantify that with a lot of precision, but yes, inasmuch as there is a finite amount of work and some of that work was being done over there rather than in the United States. The work was not being done here and therefore the U.S. workers were not doing it. So there was a loss of employment to the contractor in that case.

Mrs. COLLINS. I would assume that the Turkish Government had an interest in operating this assembly facility long after the particular sale that we talked about with which it was involved has been completed. Is that a fair assumption?

Mr. CONAHAN. That is very true, and their actions have shown that is the case.

Mrs. COLLINS. So they are still doing it?

Mr. CONAHAN. That is correct.

Mrs. COLLINS. And jobs are still being lost?

Mr. CONAHAN. Well, employment in the long run has been lost to that operation, yes, ma'am.

Mrs. COLLINS. Well, in the report you say that Egypt bought the same weapons system as Turkey using FMF funds, and that with the U.S. Government's initiative and request, each have allowed Turkey to assemble the weapons system for delivery to Egypt instead of having the weapons system assembled and delivered from the United States.

Now, this statement to me is astonishing. In this case, it was not even the foreign country that demanded the offset; the offset was provided at the initiative of our own government. Not only do the taxpayers pay for the offset, it was our own government's idea for them to pay for it.

What possible justification might there have been for this and who in our Government initiated this—I want to say lamebrain—but this idea?

Mr. CONAHAN. The simple answer to that question would be to find who signed the letter of offer of acceptance associated with this transaction, but I don't think that is a correct way of characterizing this. There are a lot of people involved in these kinds of decisions. It goes back to how best we think that we can fulfill our obligations and responsibilities to Egypt and Israel.

One thing I need to say at this point, and perhaps it is a good answer to that question, since I can't answer the question directly. Is that when you look at the individual transactions, you do not find a specific justification in terms of serving our national security or foreign policy objectives.

Mrs. COLLINS. You do not?

Mr. CONAHAN. You don't see that with respect to individual transactions. You would think that you would find that, but it is not there. It is assumed that it implements Camp David or that it somehow broadly meets our foreign policy objectives, but you don't see the specific tie-in of this transaction to specific foreign policy objective.

Mrs. COLLINS. Well, if perhaps it was done, say, during the Gulf War, could it have possibly been to cement relations with Turkey?

Mr. CONAHAN. Certainly.

Mrs. COLLINS. At a time of need?

Mr. CONAHAN. Yes, certainly.

Mrs. COLLINS. In conclusion, I don't know if I am correct or not, but I am going to ask you, am I correct that the U.S. aerospace industry is undergoing major adjustments, including the elimination of thousands of jobs and restriction of capacity, and if so, does it make sense from the standpoint of the aerospace industry base in our country, that our government would promote a policy as it did in the case of the Turkish and Egyptian sales of building and utilizing foreign aerospace production facilities?

Mr. CONAHAN. Well, clearly, Madam Chairwoman, the defense base globally is showing a reduction and a retraction, that is occurring throughout the world. Should we have a national policy that we are going to protect ours overall, or a segment of ours, I think is a good issue. But I think it is one that needs to be debated.

I think that there are a lot of voices that need to be heard on that, and I would have to defer to the national debate on that issue, rather than coming down one way or the other. You know, a defense industrial policy or an industrial policy has been an issue in this country for a long period of time, and I think I will let that debate continue without me for a while.

Mrs. COLLINS. Mr. Paxon.

Mr. PAXON. Thank you very much, Madam Chair. I appreciate the chance to participate in the hearing.

First of all, if you could just address this thought; the Congress and the administration have declared as a fundamental U.S. foreign policy goal in the Middle East a state of commitment to uphold and preserve the state of Israel's qualitative military edge. And I know that Mr. Pallone touched on this issue prior to my being here.

But I would like you to address the question, doesn't industrial cooperation which involves Israeli firms subcontracting into the U.S. defense industry actually act to preserve that qualitative edge by maintaining Israel's industrial base?

Mr. CONAHAN. I think there is no question about that, Mr. Paxon. I think any time that you assist any one of our friends or allies to involve themselves in codevelopment or coproduction, or any of these other offset arrangements that involve technology transfer, particularly transfer of these frontline technologies, that we have enhanced their ability to contribute to mutual security, and that certainly is an objective of this government.

Mr. PAXON. Further along this line, Israeli subcontractors are not guaranteed work from U.S. firms when FMF is used by Israel for defense procurements. They must compete with other companies in

the United States, sometimes winning contracts and sometimes not.

Shouldn't a U.S. company choose the most cost-effective supplier for its subcomponents in a given arms sale, even if that vendor happens to be in Israel?

Mr. CONAHAN. I think that we need there to ask ourselves whether we want to agree to that position if U.S. Government grant funding is involved. I think that if the international marketplace is at work right there, that would be the outcome of many discussions.

I am not sure that our contractors would agree with me on that, but nonetheless, that might be the outcome of it. But when you have got U.S. taxpayers' money involved, (1) in providing the equipment in the first place, and then, (2) financing the offsets, one wonders if that is serving our objective; keep in mind here that what you have got is, you know, two U.S. contractors competing with one another.

Mr. PAXON. I understand.

Lastly, have there been any cases in which Israel, which is certainly a principal FMF recipient, has Israel ever challenged a U.S. contractor with not fulfilling past offset commitments?

Mr. CONAHAN. We are not aware of any, sir.

Mr. PAXON. Israel's industrial cooperation agreements do not contain a penalty, and it has never taken action against a contractor for not fulfilling its pledge of offsets. In fact, U.S. defense firms which have fulfilled their offset commitments to Israel frequently continue to purchase items from Israeli companies because of favorable pricing and/or quality, and that has been the case as far as we can determine.

Mr. CONAHAN. Yes, we have some of that.

Now, when it comes to the enforceability of these agreements, arbitration clauses, are in there, but when it comes to bringing anything before an arbitration body you know where that takes you.

Mr. PAXON. I yield back.

Thank you, Madam Chair.

Mrs. COLLINS. Mr. Pallone?

Mr. PALLONE. Mr. Conahan, I was going to follow up on what Mr. Paxon said. And again, I use Israel as the example, because I am not really familiar with what happens with the other countries. But as he mentioned, or I think he was alluding to, that the direct offsets are gone as far as Israel is concerned; right? Those were terminated.

But now you have what I guess I would call these indirect situations, the voluntary agreements that you have mentioned. And I am just wondering, I mean, my understanding is with regard to the Israeli contracts that these agreements basically are predicated on the ability of U.S. companies to find quality, competitively priced items in Israel.

In other words, they don't require that the U.S. company simply buy the item in Israel; rather, they say that if you can—you have to make an effort to go in and find—if you can purchase this in Israel and it is competitive and it is that level of quality, then, you know, you should purchase this or set up a way of acquiring this within Israel.

Now, you stated I think as part of the GAO report in your testimony, that you would like to abolish these offsets completely as a matter of U.S. Law. Is there some way that perhaps rather than taking that position that we could sort of temper that and say that if the contracts merely require U.S. companies to search out or see if there is a quality competitive item, that those types of offsets agreements would still be allowed?

I mean, obviously, the concern here is not to negatively impact U.S. allies. I mean, the only reason we are giving aid to these countries is because we want them—their defenses to be built up because of their cooperation with the United States. I am just wondering if there is some way of, rather than just a total prohibition, that may have a negative impact on defense cooperation or the so-called "qualitative edge," that perhaps we would still allow the types of contracts that simply require that they make an effort and that they, you know, search out for a competitive item.

The other thing I was going to mention, you brought it up yourself, maybe two questions here. You mentioned that the contracts aren't specific as to U.S. foreign policy interests. Perhaps if the contracts, you know, had to specify that in some way, that might be another way of dealing with this rather than simply totally prohibiting these indirect offsets.

Mr. CONAHAN. Good.

Well, let me take the last one first, if I may.

I quite agree. As a matter of fact, in structuring our recommendation, we provided for that, that the offsets should be prohibited using FMF funding unless there are specific compelling foreign policy or mutual security objectives to be achieved. So I quite agree with you on that.

I don't think we should ever come up with a policy that says that this is absolutely across the board. So I am agreeing with you on that. I don't see any difficulty with that at all.

Now, when it comes to your first issue, Israel continues to obtain direct offsets such as coproduction. There is also precedent in the case of Israel for setting aside procurement directly from Israel to the exclusion of U.S. suppliers, and that is the $475 million that has been set up for that purpose. So I don't see a problem there either. And that is what we said from the outset, that most of these funds are required to be spent in the United States, but that $475 million may be spent offshore in Israel.

So as a national policy, we could decide to increase that amount, make it a half billion or $1 billion a year, or whatever the case may be.

Now, when it comes to a policy which suggests that you take a look at these things, and if indeed this producer here is more efficient than this producer here, it is within the realm of the policy to select this producer here rather than this producer right here.

I think that that is unnecessary. I think that unnecessarily complicates things. There is a sufficient universe out there where U.S. manufacturers, prime contractors and the U.S. Government can buy in—put the U.S. Government aside. But the U.S. Government, insofar as it is providing loans or loan guarantees, and prime contractors, there is sufficient universe in Israel and other countries for them to buy from the efficient contractor.

When it comes to the provision of grant assistance as we define it, I don't think that we would impact on their ability to buy otherwise for more efficient contractors over there, and it would be a much simpler and neater arrangement; everyone would understand the policy, and we wouldn't have the implementation problems that we might otherwise. That is where I come out on that, sir.

Mr. PALLONE. OK. Thank you.

Mrs. COLLINS. Mr. Stearns.

Mr. STEARNS. Thank you, Madam Chairwoman.

I want to talk about two things in the short time I have. One, an example there that occurred in the 1980's when Boeing agreed to furnish offsets in the amount of 120 percent to the United Kingdom in exchange for the United Kingdom's agreement to buy Boeing's AWAC's in place of the U.K.'s NIMROD system. I know that you cannot name the names of specific companies and that the U.K.'s AWAC's acquisition was not an FMF transaction, but did you find any examples of offsets in excess of the contract amount in contracts financed by FMF dollars?

Mr. CONAHAN. No, we did not. Not among these 48 contracts.

Mr. STEARNS. Why would a contractor enter into a contract like the one I just mentioned and give back to the other party more than it was receiving in the first place?

Mr. CONAHAN. Well, I think that what we need to do is to take a look at the specifics of those offsets. The contractor is not necessarily giving back much of anything, in some cases, or at least he judged that the cost is worth getting that contract. You are talking about a McDonnell-Douglas getting a contract over a Lockheed for, you know, several billions of dollars.

Now, most of those costs are going to be passed on to someone else; they are going to be passed on to the buyer, if you have got that kind of a situation. And in some cases, they are going to be passed on to other customers outside of the weapons system altogether.

I said earlier on that the cost of these offsets to the U.S. contractors is not insignificant, and it is not. And they are willing to pay a fair amount for those things.

But you are talking about very, very large sales. You are talking about sales in the billions of dollars. And they are interested in winning the sale, whether it involves a foreign or a U.S. competitor.

Mr. STEARNS. I just want to explore in the remaining time I have, enforcing offset prohibitions. Let me read: The President announced a policy, later codified in the Defense Production Act, October 5th, 1992, on offsets in 1990, which provides that U.S. Government funds shall not be used to finance offsets in security assistance sales except, "in accordance with currently established policies and procedures."

I think the GAO has criticized this policy because it does not constitute, "currently established policies and procedures." So my question is, if we had a law indicating that you could not use offsets, what is currently established policies and procedures?

Mr. CONAHAN. I think that you put your finger on the problem right here. That policy was established in 1990, I think you just gave the month, in 1990, and it said that government funds shall

not be used to finance offsets and security assistance sales, "except in accordance with currently established policies and procedures." That proviso, "except in accordance with currently established policies and procedures," was not explained.

It was not explained at that time, nor was it explained a couple of years later when it was incorporated into the Defense Production Act. It just simply was not explained.

However, in point of fact, at that time in 1990, and in 1992, there was a host of offsets occurring. You know, coproduction, buybacks, the whole gamut of offsets were occurring back then. So that provision, "except in accordance with currently established policies and procedures," covered what was going on at that time.

Nothing has changed since that time. There has been some legislation very, very recently which ruled out one particular kind of offset, but I don't think we need to discuss that at the moment. So you have the situation today as it existed in 1990.

I think all too often we see regulations written—and I know that in this building it is a very difficult position to say the law is written in such a way that it looks as though we are saying one thing—but in point of fact we are permitting other things to occur. And I think that is what we have right here. We have a law, that you think is pretty clear, "funds shall not be used to do" thus and so. But the fact of the matter is, it doesn't mean a thing.

Mr. STEARNS. Let me ask you, suppose that Congress started another statute, the executive branch had a regulation, an Executive order prohibiting offsets under such circumstances. How would we enforce such law? I mean, is it possible that we can enforce this?

Mr. CONAHAN. Well, I think that it is very, very difficult. But one thing that you could do is get the U.S. contractor involved in these transactions to certify to the U.S. Government that it will not offer or provide offsets in connection with this particular transaction.

Now, the enforceability of that in a court of law I leave for the lawyers to argue somewhere down the road. But as a starter, it seems to me that that would focus great attention on what is going on right here. And if we visited and revisited this issue often enough, perhaps we could make it work.

Mr. STEARNS. Thank you, Madam Chairwoman.

Mrs. COLLINS. Mr. Greenwood.

Mr. GREENWOOD. Thank you.

Earlier in your testimony, you said that as you have examined these contracts, one of the things you noticed was that there didn't seem to be clear policy as to how this particular arms sale was implementing U.S. foreign policy. There didn't seem to be a clearly defined policy mission involved in each of these contracts. Is that what you said?

Mr. CONAHAN. With respect to the documentation associated with the individual transaction, I did say that, yes, sir.

Mr. GREENWOOD. OK. Which raises in my mind a larger question: if we agree that these offsets are not a good thing, are not conducive to maximizing the tax dollar or the American jobs that flow back to the United States, and on top of that, at least in your study, you are noticing that these FMF sales don't seem to be maximizing our foreign policy, it leads me to wonder why we do it in the way that we do it? Why do we give the fungible cash to the

other nations and let them be in charge of (1) how the contracts are arranged with regard to offsets; and (2) what it is that they choose to do with those funds, regardless of what our policy is.

And I am wondering if we have to go all the way and engage only in programs in which the U.S. Government uses these funds to both decide through negotiations and bilateral agreements what defense capabilities it is that we want to purchase for these nations? Then the U.S. Government would negotiate these contracts, and then you wouldn't have a question of enforcing new offsets except as an internal U.S. Government matter.

Am I missing something here? I have only been around for a year and a half.

Mr. CONAHAN. No. But there could still be offsets on the side that the U.S. Government doesn't have cognizance of, and I would have some concern with that. I guess the question I would raise in considering your proposal is to what extent will the U.S. Government be directing the defense article to be procured by that foreign government?

I think we have to think about that. You know, do we say to an Israel, "buy the F-15 rather than the F-16," or do we say to another country, Turkey, buy the F-18 rather than the F-15. I think we have to worry about whether your proposal—and I am not arguing your proposal at the moment—I think we have to think it through, though, to make sure that we can bring that off without the U.S. Government having a directive role in what these governments should be buying from us, unless as a national policy we decide we want to have such a defense industrial policy. And I am not sure we are there. So that—plus the fact that we have to come up with an arrangement for assuring that they don't have these offsets on the side. Otherwise, I think you can get there.

Mr. GREENWOOD. Well, it would seem to me from my admittedly perhaps naive position, that when we are using 100 percent tax dollars, with no pay-backs, this is a grant. Another nation says to us, "We think we need this kind of tank or this kind of aircraft," that we ought to at least have a nod that says, yes, "We agree you need that one." And then I don't see a problem whatsoever with us saying, now, "We will buy it for you and we will negotiate with the U.S. defense contractors and make sure that we get the best bang for our dollar, and then the defense contractor will deliver that military equipment to you."

Mr. CONAHAN. I fully agree with that prescription, right there, from beginning to end, as you have laid it out.

Mr. GREENWOOD. Thank you.

Mr. CONAHAN. And we do some of that right now.

Mr. GREENWOOD. I can't think of a reason why we don't do it all that way.

Mr. CONAHAN. Absolutely.

Mr. GREENWOOD. It has occurred to me that I should ask you what happened when we tried to do that last year?

Mr. CONAHAN. Ms. D'Agostino will address the DOD's policy to eliminate direct commercial contracts when FMF funds are used.

Ms. D'AGOSTINO. DOD made an effort to prohibit direct commercial contracts with FMF funds, and in fact issued policy memorandums that were cleared all the way up to the Secretary of Defense.

Last year, I believe that some legislation was passed in the appropriations bill that basically said: We are going to put that policy off for several months until there can be a number of consultations with the affected countries.

The only country that I am aware of who raised an issue over the new policy was Israel. And they were concerned that they would not be able to buy equipment quickly and buy nonstandard equipment without being able to go through direct commercial channels. And so, in any case, consultation is still going on, to my knowledge.

Mr. GREENWOOD. Thank you.

Thank you, Madam Chairwoman.

Mrs. COLLINS. Mr. Conahan, I am interested in knowing a little more about how offsets are accounted for from an accounting standpoint. Can you tell me how offsets should be treated as allowable expenses in foreign military sales contracts with grant aid from under the Foreign Military Financing Program?

Wouldn't that offset cost be disallowed under Federal Acquisition Regulation?

Mr. CONAHAN. There are several kinds of costs associated with offsets, and we have to begin by recognizing that and talking about them in that manner. The regulations right now allow certain marketing costs to be charged to the overhead pools of the defense contractors, with those costs being allocated as indirect costs across all contracts that the defense contractor has.

For example, if a contractor has a sales office in Cairo and it is marketing for that contractor on a day-to-day basis, and charges that cost into its overhead pool, then that would be appropriately charged into a government contract as part of overhead. Now, if you are talking about a direct charge of implementing an offset, it can get recovered in that particular foreign contract.

If you are talking about grant financing in a government-to-government sale, it is not an allowable charge. But in a direct commercial sale, the Federal acquisition rules don't clearly apply.

Mrs. COLLINS. OK. So you are saying then that a taxpayer-funded direct commercial contract, the U.S. contractor can include offset costs without any penalty?

Mr. CONAHAN. That is correct, right.

Mrs. COLLINS. OK. I want to make sure I had my head clear on that one.

Your report states that certain offset administrative costs incurred by U.S. contractors are charged to overhead pools, and allocated to other domestic contracts. Now, what is the significance of these charges being made by the U.S. contractors to other domestic contracts, including the U.S. Government contracts?

Mr. CONAHAN. Well, if you stop to think about the contractors that are involved here, very little of those costs get allocated to domestic business. You are talking about some of these big contractors, most of their business is defense, and therefore, those overhead costs are going to get charged into defense-related contracts. So the U.S. taxpayer is going to end up paying for most of it.

Mrs. COLLINS. So charging offset administrative costs to overhead pools is contrary, is it not, to Defense Contract Audit Agency guidelines?

Mr. CONAHAN. Let Ms. D'Agostino talk to that.

Ms. D'AGOSTINO. The DCAA contract audit guidance says that companies are not supposed to put their offset implementation costs into U.S. Government contracts, that they need to be allocated to whatever contract caused them to exist. We found at two companies, that they were, in fact, rolling these costs up into overhead and spreading them all around, in contravention to the audit guidance.

We looked through the acquisition rules, and DCAA's guidance is not specifically reflected anywhere in those rules. But that is their interpretation of the rules. And we are talking about a few million dollars in the cases we saw.

Mrs. COLLINS. Well, let me ask you this question.

Did you make the Defense Department aware of what you found, and if so, are the U.S. companies subject to any kind of penalty for having done this?

Mr. GROVES. In those particular cases, we have not alerted the DOD people. We were waiting until the report was made public before we addressed that particular issue.

Mrs. COLLINS. So I can assume that you intend to notify the Department of Defense?

Mr. CONAHAN. We certainly will, forthwith, and we would expect that those costs would be backed out.

[The following information was received:]

On June 23, 1994, GAO provided the Defense Contract Audit Agency with the names of the two U.S. contractors and the specific amounts of administrative offset costs allocated to other contracts, including those with the U.S. Government. In response, the Agency requested its appropriate field offices to assess, as part of their ongoing audit efforts, the U.S. contractors' compliance with its guidance on allocating administrative offset costs associated with foreign military sales.

Mrs. COLLINS. The Defense Department says its policy is not to get involved with offset negotiations and agreements between a contractor and a foreign government. Obviously, that was not the case in the decision to assemble weapons in Turkey or Egypt.

Did you find other examples in your investigations of the Defense Department's involvement in offset negotiations and agreements?

Mr. CONAHAN. Well, in the case of Turkey, I think there was a direct involvement in that. As a matter of fact, when we talked to the contractors, they said that they felt that they were being directed by the U.S. Government in many of these cases to get involved in offset agreements, that it was in the U.S. Government interest that these offset arrangements be consummated and that the defense contractor should agree to that.

Mrs. COLLINS. Who directed them?

Mr. CONAHAN. The U.S. Government, the Department of Defense. You got to watch that word. You know, the defense community is reliant upon the Department of Defense for substantial sums of money coming their way each year. There is intense competition, whether foreign firms are involved or not. And these firms are interested in doing as much as they can in order to assist the Department of Defense in doing what it feels it needs to be done. And offsets in this case have been a normal way of doing business without anyone shining a harsh light on them, and so this is what we found to be rather routine and normal.

Mrs. COLLINS. Well now, let me ask you about some other countries. What about France and Germany and the United Kingdom and other countries?

I understand that they help their defense industries compete by providing offsets and financing assistance such as guaranteed loans. However, these countries don't have any programs like ours under which public funds are used to provide a combination of funds together with offsets to enable contractors to compete in the world market. But my question is, is the United States the only country that uses public funds to finance weapons purchases for foreign governments and the offsets associated with these contracts?

Mr. CONAHAN. As far as we can determine, Madam Chairwoman, the United States is the only country that uses grant funds for these purposes.

Mrs. COLLINS. So the U.S. taxpayers get hit twice?

Mr. CONAHAN. That is correct.

Mrs. COLLINS. And lose jobs?

Mr. CONAHAN. And lose jobs.

Mrs. COLLINS. And some of their companies lose business.

Mr. CONAHAN. I think that is absolutely true.

Mrs. COLLINS. Incredible.

I guess my final question; do you recommend that Congress legislatively prohibit U.S. contractors from providing offsets in association with FMF taxpayers' financed arms sales to foreign governments?

Have you consulted with defense contractors, subcontractors, the defense department and others in making your recommendations, and if so, what have they said?

Mr. CONAHAN. Well, I think that if the recommendations could be implemented effectively, that both the defense establishment, that is the U.S. Government part of the defense establishment as well as the contractors would agree. And I would hope that we could implement our series of recommendations effectively. So I think that we would get agreement from both DOD and the contractors on that.

The concern out there is on effective implementation. And we have a corollary recommendation that goes to assisting the effective implementation of the recommendations as well.

Mrs. COLLINS. Well, I thank you very much for appearing before our subcommittee today.

I am signing a letter right now to Secretary of Defense Perry asking him some questions about this, and I hope to get some answers back in a very short period of time.

I want to thank each of you for attending our hearing today and for the forthrightness with which you have given your responses.

This hearing is adjourned.

Mr. CONAHAN. Thank you very much.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[The letter referred to and response follow:]

ONE HUNDRED THIRD CONGRESS

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Committee on Energy and Commerce

SUBCOMMITTEE ON COMMERCE,
CONSUMER PROTECTION, AND COMPETITIVENESS

Washington, DC 20515–6120

July 12, 1994

The Honorable William J. Perry
Secretary
Department of Defense
The Pentagon
Washington, D.C. 20301-1155

Dear Mr. Secretary:

I am writing in regard to a charge that certain costs of providing offsets to foreign governments have been improperly allocated by U.S. Defense contractors to the U.S. military and other customers. This charge was made in testimony presented by the General Accounting Office (GAO) at a hearing of the Subcommittee on Commerce, Consumer Protection, and Competitiveness. The hearing was held on May 22, 1994, and concerned a GAO report entitled "Military Exports--Concerns Over Offsets Generated With U.S. Military Financing Program Funds".

In the investigation on which the report is based, GAO reviewed 48 contracts between U.S. defense contractors and foreign governments. In particular, GAO wanted to identify any offsets provided in association with these contracts and how the contractors handled the costs associated with these offsets.

I was especially concerned to learn at the hearing that GAO found instances in which U.S. defense contractors "rolled up" the administrative costs of providing offsets to foreign governments into general "overhead pools" that are then allocated to all customers of these U.S. contractors, including the U.S. military.

According to GAO, allocating offset costs to our military and other U.S. customers violates Defense contractor audit guidelines. I am therefore requesting that your Department contact GAO and initiate action immediately to assess the charge GAO has made and to disallow and to recover these offset costs which were improperly allocated.

I want to thank you for your cooperation. I would also like to request that you respond to me by close of business on Thursday, July 21, 1994, concerning the action you have taken on this matter and the results that have been achieved.

Sincerely,

Cardiss Collins

CARDISS COLLINS
Chairwoman

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

ACQUISITION AND TECHNOLOGY

JUL 21 1994

DP/FC

Honorable Cardiss Collins
Chairwoman, Subcommittee on Commerce,
Consumer Protection, and Competitiveness
Committee on Energy and Commerce
House of Representatives
Washington, DC 20515-6120

Dear Madam Chairwoman:

Your letter of July 12, 1994, to the Secretary of Defense refers to a report by the General Accounting Office (GAO) entitled, "Military Exports--Concerns Over Offsets Generated With U.S. Military Financing Program Funds," and to related testimony by the GAO before your Subcommittee. The GAO charges that contractors have included certain costs associated with offsets in their overhead pools, and have allocated these costs to Department of Defense contracts. Your letter requests that we contact GAO and assess this charge by the GAO.

We are making arrangements to meet with GAO in accordance with your request, and will communicate further with you after we have had an opportunity to look into the issue.

Sincerely,

Carol Covey
for Eleanor R. Spector
Director, Defense Procurement

cc:
Honorable Clifford B. Stearns
Ranking Republican

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